

October 31, 1991

**COORDINATED ISSUE  
SECURITIES & FINANCIAL SERVICES INDUSTRY  
REVERSE CONVERSIONS**

**ISSUE**

Is the net loss which arises from the put and call options in a reverse conversion transaction properly characterized as an ordinary loss or a capital loss?

**FACTS**

Reverse conversion is an arbitrage technique typically used by securities dealers that initiate exchange transactions from the floor of the exchange (these dealers are referred to as "upstairs firms") to take advantage of pricing inefficiencies between the premium of a call option and the premium of a put option with an identical strike price and expiration date (a "corresponding put"). Reverse conversions are particularly attractive to upstairs firms, because upstairs firms pay no commissions on stock or options transactions, and because such firms have access to their customers' stock at little or no cost to the firms, to satisfy short sale delivery obligations that arise from reverse conversions. Reverse conversions effectively lock in a fixed borrowing rate with little or no market risk.

In a reverse conversion, the securities dealer sells stock short, writes a put, and buys a call. The reverse conversion equation is as follows:

$$\text{SHORT STOCK} + \text{LONG CALL} + \text{SHORT PUT} = \text{NO MARKET RISK}$$

Short Stock -- In a short sale, the taxpayer sells property he does not own, and receives the cash proceeds from the sale. The taxpayer borrows the property sold, and closes the short sale by later purchasing the property sold short and delivering the property back to the lender.

Generally, the proceeds from a short sale are deposited with the lender of the stock as collateral, and the lender earns interest a portion of which is rebated to the borrower. However, a securities dealer may sell short stock borrowed from customer margin accounts, and use the short sale proceeds to generate interest income elsewhere, or apply the proceeds against outstanding borrowings to reduce interest expense. A reverse conversion will be profitable if the interest earned from the short sale exceeds the net cost of the long call, short put position.

Long Call -- A taxpayer who buys (or goes "long") a call option has the contractual

right to buy the underlying interest (in this case, a specified number of shares; generally one option contract entitles its holder to buy 100 shares) at a specified price (the "strike price") on or before a specified date (the "expiration date"). The purchaser (or "holder") must pay a premium to the call seller (or "writer") for granting the option. If the underlying stock or other property increases in value before the expiration date, the call option can be sold or exercised for a gain; if the value of the underlying property decreases, the call option will not be exercised and will expire worthless. The purchaser of an option will not lose more than the premium paid to acquire the option.

Short Put -- A taxpayer who sells (or goes "short") a put option receives a premium for granting the purchaser of the put option the contractual right to sell the underlying property at the strike price on or before the expiration date. If the underlying property decreases in value before the expiration date, the put option will be sold or exercised by the put holder. In this case, the cost of the underlying property to the put writer is the strike price minus the premium. If the underlying property increases in value before the expiration date and the put is not exercised by its holder, the writer nevertheless earns the premium.

### **REVERSE CONVERSION EXAMPLE**

Reverse conversion arbitrage will produce profit to the extent that rebate payments from the short sale exceed the locked in trading loss. If the calls are "in-the-money" (i.e., the strike price is less than the market price) at expiration they will be exercised by the firm to acquire the stock to close the short stock position. If the puts are "in-the-money" (i.e., the strike price is greater than the market price) they will be exercised by the holder, and the firm will acquire this stock to close the short stock position. In either case, the out-of-the money option will expire worthless.

Reverse conversions arbitrage can be demonstrated using the following example:

On August 31, 1989, Taxpayer, a securities dealer, enters into the following transaction:

Sell short 1000 shares of X @ 39½. . . . . 39,500

Buy 10 December '89 calls, strike price 40,  
@ 3½ (each call entitles holder to 100 shares,  
100 x 3½ = \$350 cost per call) . . . . . (3,500)

Sell 10 December '89 puts, strike price  
40, @ 3 (each put entitles holder to  
100 shares, 100 x 3 = \$300 premium

received per put) ..... 3,000

Total proceeds received ..... \$39,000

Taxpayer thus has the use of \$39,000 (short sale proceeds of \$39,500 less \$500 net cost of options) on September 1 to generate interest income or reduce interest expense. Taxpayer will lose \$1,000 (\$500 difference in short sale price of stock and strike price of options, plus \$500 difference in the premium paid and received for the options) on the trade regardless of the price of X stock on the expiration date of the put and the call on December 15, 1989 (options expire on the third Friday of each month):

(1) Call in-the-money:

The price of X stock increases in value to \$100 on December 15, 1989. Taxpayer will exercise the long call at \$40, the short put will expire worthless, and Taxpayer will use the stock received from exercising the call to close out the short sale. The cost to Taxpayer is \$40,000 (1000 shares of X @ \$40). The loss on the transaction is \$1,000 (\$39,000 proceeds received less \$40,000 cost).

(2) Put in-the-money:

The price of X stock decreases in value to \$10 on December 15, 1989. The long call will expire worthless, and the holder of the put will exercise and put the stock to the Taxpayer at \$40, which Taxpayer will use to close out the short sale. The cost to Taxpayer is \$40,000 (1,000 shares of X @ \$40 less the \$3000 premium earned on the short put). After taking into account the \$3500 cost of the call option, the loss on the transaction is \$1,000 (\$39,500 proceeds received less costs of (\$37000 plus \$3500).

Taxpayer thus has the use of the \$39,000 proceeds from these positions for 106 days (September 1 through December 15). Taxpayer will have an economic profit if it can earn more than \$1,000 (the loss on the transaction) on the proceeds during this time period. Put another way, Taxpayer can make an economic profit on the transaction if it can receive a rate of return on the proceeds in excess of 8.8%, computed as follows:

<u>\$1,000 loss</u>	Divided by: <u>106 days</u>
\$39,000 received	365 days

This example assumes that there are no "in lieu of dividends" payable by Taxpayer to the lender of the underlying stock sold short prior to the expiration of the options. The interest generated by the short sale proceeds would be offset by payment of these

dividends, since Taxpayer, as the short seller, is responsible for any dividends paid on the stock which it borrows.

## **LAW**

Section 1211 of the Code provides as a general rule that losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges. Therefore, if the loss generated from the options position is classified as a "capital loss", such loss could not be offset against the ordinary interest generated from the short sale proceeds.

Sections 1233 and 1234 of the Code provide that generally, the gain or loss attributable to the closing of short stock or option contract positions is considered capital gain or loss if the underlying property (in this case, stock) is a capital asset in the hands of the taxpayer. See sections 1233(a), 1234(a), and 1234(b) of the Code. However, section 1234(a)(3) provides that subsection (a) (relating to the tax treatment of gain or loss in the case of the purchaser of options to buy or sell) shall not apply to an option which constitutes property described in paragraph 1221(1) (i.e., is inventory property or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business). Similarly, section 1234(b)(3) provides that subsection (b) (relating to the tax treatment of gain or loss in the case of a grantor of options) shall not apply to any option granted in the ordinary course of taxpayer's trade or business of granting options. Thus, the loss from a reverse conversion transaction will not be considered a capital loss under section 1234 if the options purchased are considered inventory property under section 1221(1) and the options granted are granted in the ordinary course of the taxpayer's business.

Although a dealer in securities typically holds stock options for sale to customers in the ordinary course of business, generally producing ordinary gains and losses, an argument can be made that the options acquired as components of a reverse conversion are not inventory property and are not acquired in the ordinary course of business, but rather, are capital assets, which create capital losses.

Reverse conversions are utilized by dealers for a valid business purpose: to generate cash at the lowest effective cost to the firm. Under the Supreme Court decisions of Corn Products Refining Company v. Commissioner, 350 U.S. 46 (1955) and subsequent cases, which carved out a nonstatutory exception to "capital asset" as defined under section 1221, the gain or loss from this type of business transaction may have been classified as ordinary gain or loss. The Court in Corn Products held that where a corn products manufacturer, as an integral part of its manufacturing business and to protect itself against rises in the price of raw corn, bought corn futures as a "hedge", profits from the resale of the futures were taxable as ordinary income rather

than as capital gains. The Court stated that even though the corn futures did not come within the literal language of the exceptions listed in section 1221 of the Code for stock in trade, actual inventory, etc., such futures nevertheless were not "capital assets" under section 1221. The Court reasoned that "... the capital-asset provision of section [1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." 350 U.S. 46 at 52.

In Arkansas Best Corporation v. Commissioner, 108 S. Ct. 971 (1988), 1988-48 I.R.B. 6, the Supreme Court reviewed its decision in Corn Products and concluded that whether the taxpayer acquires an asset for a business purpose or an investment purpose is irrelevant in determining whether the asset falls within the definition of a "capital asset" under section 1221. In Arkansas Best, the taxpayer, a diversified holding company, acquired additional shares of stock in a bank for the business purpose of saving the bank from failure and preserving the taxpayer's reputation. The taxpayer sold the bank stock at a loss and, relying on Corn Products, claimed an ordinary loss.

The Court held that the taxpayer's interpretation of Corn Products as authorizing ordinary asset treatment for any asset acquired and held for business rather than for investment purposes was too expansive. The Court chose to read section 1221 literally, rejecting the "business-motive test" and taxpayer's contention that the five listed exceptions from the definition of capital asset under section 1221 were illustrative rather than exhaustive. The holding in Corn Products was confined to stand for the narrow proposition that "hedging" transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of section 1221, since such transactions may be considered substitutes for actual inventory. Since the taxpayer's stock in Arkansas Best fell within the broad definition of "capital asset" under section 1221, and was outside of that section's five classes of excluded property, the taxpayer's loss of the stock was held to be a capital loss.

## **CONCLUSION**

The components of a reverse conversion transaction entered into by a securities dealer, albeit for a valid business purpose, are not held by the dealer as inventory, and are not substitutes for inventory. Since the components are not inventory and do not fall within the other excluded classes of property under section 1221, they would be classified as "capital assets" under that section according to the reasoning in Arkansas Best. As such, any loss generated by the transaction would be capital loss.